Appalachian Regional Commission

Development Venture Capital Fund
Application and Operating Guidelines

September 1, 2000

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I. Overview

Despite robust economic growth nationally, structural changes in declining sectors such as coal mining, manufacturing, textiles, and agriculture—exacerbated by globalization and technological change—have hit Appalachia disproportionately hard, threatening to reverse the modest economic gains that many Appalachian communities have made.

Appalachia's future economic vitality—and the future vitality of rural America—in large measure depends upon nurturing home-grown firms, encouraging innovation and risk-taking, and enhancing investment in new businesses. While the Region has several outstanding examples of entrepreneurial communities and organizations and possesses many entrepreneurial assets, including the self-reliance of its people, it also faces many challenges. These entrepreneurial shortcomings stem from Appalachia's longstanding dependence on extractive industries and branch plant manufacturing, and the presence of many absentee landlords who have siphoned off value from the Region. Furthermore, the culture of entrepreneurship is neither broad nor deep throughout Appalachia, and research findings indicate that there are many gaps in the infrastructure for supporting entrepreneurship, ranging from technical assistance to development finance.

ARC views entrepreneurship as a critical element in the establishment of self-sustaining communities that create jobs, build local wealth, and contribute broadly to economic and community development. Appalachia needs to cultivate resourceful entrepreneurs who not only create value by recognizing and meeting new market opportunities, but who increase the value-added within the Region.

Responding to these conditions, in 1997 ARC launched a multi-year, $15 million Entrepreneurship Initiative to build entrepreneurial economies across Appalachia. Through these activities, ARC has learned how entrepreneurial activity can be nurtured through a variety of educational, business assistance and capacity building initiatives. ARC has focused support on four areas that support the infrastructure necessary for creating entrepreneurial economies:

- Entrepreneurial education and training, both for existing business owners and youth;
- Improving access to debt and equity capital for growing firms;
- Developing entrepreneurial networks, particularly those focused on strategic industries; and
- Technical and managerial assistance, with a special focus on Appalachia's business incubation strategies and needs.

Through this Entrepreneurship Initiative, the Commission has funded projects that include: support for youth entrepreneurial education like the REAL Enterprise program; capitalization of micro-business lending programs and support for technical assistance intermediaries; targeted support for specific strategic industries such as wood products, value added food processing, and ceramics manufacture; and support for business incubators. In each of the four areas that support an entrepreneurial economy, ARC has convened advisory committees composed of regional practitioners and state partners to help ARC both stimulate innovative programming and bring additional resources and expertise into the Region.

ARC has in the past successfully "primed the pump" of local capital markets by providing capital for revolving loan funds (RLFs) that are operated by Local Development Districts (LDDs). To date, ARC has provided over $30 million in grants to 31 RLFs. These RLFs in turn have made more than $64 million in loans to businesses in their communities.

While ARC has historically focused on debt funds, several studies have identified access to equity capital as a significant constraint to growth for many rural businesses.[1] Equity is crucial for almost any business, since it can fund future growth, allow experimentation with new products and business lines, provide a cushion for the ups and downs of a business' cash flow cycle, and leverage debt financing. From a public policy perspective, access to equity capital is a critical part of supporting higher growth businesses and creating related jobs. The location and expansion of such businesses in distressed communities is of particular importance to policymakers.

Given the dearth of equity funds in Appalachia and the need for risk capital to support growing businesses, ARC has undertaken a range of activities to encourage formation of new Development Venture Capital funds in the region.

II. Objectives and Strategies

The primary objectives of the ARC Development Venture Capital Fund program include:

- Private sector job creation;
- Generation and retention of wealth in local rural communities;
- New business formation;
- Stability and growth of portfolio (investee) companies;
- Leveraging of private sector dollars; and
- Flexibility and financial stability of the investment institution—the DVC fund.

ARC support may be used to both capitalize DVC funds and to cover the costs of fund operations. Applicant DVC funds are encouraged to pursue other federal investment programs, including the U.S. Department of Treasury's Community Development Financial Institutions Fund (CDFI Fund) and the U.S. Small Business Administration's Small Business Investment Corporation (SBIC) program.[2] Participation by DVC funds in the CDFI and SBIC programs could be a strong positive factor in ARC's consideration of grant applications, as these programs broaden the capitalization and training opportunities available to candidate funds.

Development Venture Capital (DVC) funds apply the tools of venture capital to fuel business creation and expansion, create good jobs, and improve the lives of people in economically distressed communities. DVC funds include non-profits, for-profits, and quasi-public organizations. Their structures include corporations, limited partnerships, community development corporations, limited liability companies, and Small Business Investment Companies (SBICs). Investors in DVC funds include foundations, banks, insurance companies, utilities, other corporations, government agencies, and private individuals. They invest because

[1] See Bibliography, Appendix A.
[2] See Resources, Appendix B.

of an interest in a "double bottom-line" that considers both the social and financial returns of the funds.

DVC funds make equity and equity-like investments in small and medium-sized businesses that hold the promise of growth through new products, new processes, or market expansion. From a development standpoint, these locally owned companies provide social benefits to distressed communities in the form of good jobs, growing industries, and the accumulation of local wealth. From a financial perspective, the return on these investments provides the capital to support the continued operation of the DVC fund and to maintain the fund's capital pool for additional investments. Thus, DVC funds must balance two goals to achieve a "double bottom-line"; they must 1) improve the economic health of distressed communities and 2) ensure a fund's ability to continue operations without subsidy and make future investments. In contrast, traditional financial institutions, such as private venture funds, principally make investment decisions on the basis of expected rate of return.

DVC funds do much more than provide capital to growing companies in distressed communities. As serious investors with an interest in the success of their portfolio companies, they also provide intensive technical assistance and in some cases become almost working partners with entrepreneurs. Like traditional venture capital investors, representatives of the DVC fund may sit on the board of directors, help identify and structure additional financing, make contacts with customers and suppliers, help with executive recruitment, and may even provide day-to-day managerial assistance. They become experts in the industries in which they invest and work alongside business owners to ensure the success of the businesses. For businesses in low-income areas, this assistance is often as crucial as the financing itself.

DVC Funds can provide financing when equity capital is not otherwise available on terms and conditions that would permit accomplishment of a project. Additionally, DVC Fund investments can solicit and leverage the participation of traditional venture capital funds for projects that might otherwise go unnoticed.

III. Grantee Requirements

A. Eligible Applicants

Eligible applicants for ARC support for equity funds include governmental entities (States, Local Development Districts, etc.) and non-profit organizations (community action agencies, community development corporations, etc.) that serve the Appalachian region. Non-profit subsidiaries of for-profit DVC funds are also eligible to receive ARC support. Applicant DVC funds must be located in the Appalachian region in order to retain capital and develop an experienced equity management pool within the region.

Applicants must demonstrate the legal authority and capacity to make equity investments. An applicant may identify an appropriate division or subsidiary of its organization to undertake programmatic activities. Because DVC Funds often do not have a fixed life, that is, they continue operations indefinitely as equity investments are repaid, priority consideration will be given to applicants that can administer the DVC Fund on a long-term basis.

B. Staff Capacity

Each equity fund must have sufficient staff capacity (or access to such capacity) to properly manage the fund and associated programming. Fund management should typically have expertise in the following areas: financial analysis and accounting; negotiation, deal structuring, and law; business assistance, portfolio monitoring, and workouts; and program and policy development. A fund can address these needs through:

- One or more experienced staff members;
- A co-investment or other contractual relationship with an experienced DVC fund;
- One or more experienced and engaged members of the fund's Investment Review Committee; or
- Other creative approaches to gaining the requisite expertise.

Experienced management is one of the most difficult issues facing DVC funds in general, and funds in Appalachia in particular. Because the universe of existing developmental venture capital funds is so small, it would be difficult for DVC funds to find managers from existing sources within Appalachia. In the event that DVC funds cannot find experienced managers, they could hire (a) person(s) with a strong finance background, an understanding of economic development, and a familiarity with the target market. Additionally, new funds should consider developing mentoring and training relationships with experienced DVC or venture capital funds.

C. ARC Grant Application Requirements

As required by the Appalachian Regional Development Act, applications for grant assistance must be submitted by the Appalachian State representing the applicant. The proposed project must support the State's Strategy Statement that describes the State's program for achieving the goals and objectives contained in the State Development Plan. For more information about applying to ARC for a grant, please visit **www.arc.gov**.

The applicant must submit a sound, feasible business plan for the proposed fund that demonstrates a high likelihood of success in achieving the defined project goals in the projected time frame.

D. DVC Fund Business Plan Requirements

Each applicant equity fund must prepare a business plan. The business plan content required by the CFDI Fund and the SBIC program can likely be submitted to fulfill ARC business plan requirements. The business plan should address many of the same issues as the operating plans required for RLFs funded by ARC, including:

a. Market focus—including competition, partners and deal flow;
b. Fund management—including staff capacity and Investment Review Committee;
c. Capitalization—including matching funds and financial pro-formas;
d. Investment profile—including investment process, structure, rate of return and exit strategies;
e. Technical assistance and portfolio administration; and
f. Programmatic impact.

a. Market Focus—Competition, Partners, and Deal Flow. An applicant must define a geographic market for its investments that is large enough to offer adequate deal flow, but small enough so that the fund can effectively monitor its investments. The applicant must provide an overview of the target region, including a description of the existing business and industrial base, the overall business climate, competitive strengths and weaknesses of the market area, and trends and prospects. A focus for the fund in addition to a geographic one, such as an industry focus, could also be detailed. (Industry focus and expertise can increase the likelihood for success of a fund, since it leads both to better investment decisions and to higher value added for the portfolio companies.)

The applicant must detail other sources of investment capital in its proposed market area, including venture capital funds (development and otherwise), Small Business Investment Corporations, state-sponsored programs, and active angel investors.

An applicant equity fund must document effective demand for DVC equity dollars in its target market. For example, a fund could examine current venture capital activity in its market area, demand for bank and SBA loans and non-bank debt financing, results of banker and businessperson surveys, overall business starts and expansions, or provide examples of specific firms requiring investment capital. The fund should also articulate marketing strategies to potential investment partners and referral sources, and identify institutional support and partners for efforts throughout the target region.

b. Fund Management—Staff Capacity and Investment Review Committee. The issues of staff capacity have been addressed in Section B, above.

An applicant equity fund must have a strong and effective Investment Review Committee, subject to some of the qualifications detailed above in Section B, Staff Capacity. For example, Investment Review Committee members could include:

- An experienced venture capitalist;
- An "angel" investor (a private individual who has previously invested in a number of small companies);
- A businessperson who has started and managed one or more small businesses that received outside equity investments;
- A business consultant with significant expertise in raising capital for firms;
- An investment banker;
- An accountant specializing in small, fast-growing firms; and/or
- An executive recruiter.

Applicants must detail how the Investment Review Committee has the desired level of investment experience, or how the investment review and approval process will incorporate sufficient expertise from other sources. Applicant funds must also detail the level of involvement and the type of information provided to Investment Review Committee members in the due diligence-deal review process.

An applicant fund must also address potential or actual conflicts of interest the fund or its management may have in implementing programmatic activities. The fund must discuss how it plans to deal with those conflicts. Issues surrounding DVC funds and conflict of interest issues are discussed in more detail below in Section IV.

c. Capitalization—Matching Funds and Financial Pro-Formas. An operating budget and capitalization plan for the fund must be clearly articulated. ARC is interested in supporting self-sustaining funds, and financial projections should clearly indicate a fund's ability to become self-sustaining. Of particular importance is the fund's ability to cover operating expenses prior to exiting the initial round of investments, as well as the ability to make follow-on investments (see "Investment Profile" below). Smaller funds that plan to rely on subsidy to support a portion of operational expenses must identify committed and potential sources of that subsidy.

Pro-forma income statements, balance sheets, and cash flow projects for at least five years must be provided. If relevant, three-year historical financial statements must also be provided.

ARC requires that each fund match its investment at the fund level. Commitments from other fund investors should be itemized, and letters of commitment included in the application. ARC will not require a match at the individual deal level, as it does with its RLF program, however, certain restrictions may apply depending on the type of county in which the investment is made. In general, ARC may not provide more than 50% of the total corpus of a DVC fund. However—in practice—DVC funds typically require multiple investors to meet their capitalization targets, and ARC's participation would likely provide only a small portion of the capital required by the fund.

At the individual deal level, no more then 30% of the project funding may be provided to a portfolio company in an ARC competitive county, and ARC participation is not permitted in an ARC attainment county.

In general there is a ceiling of $1,000,000 in ARC support on the initial capitalization of a DVC fund. The Federal Co-Chairman may approve a higher capitalization level based upon a near-term demonstration of equity investment fund utilization.

d. Investment Profile—Investment Process, Structure, Rate of Return, and Exit Strategies. An equity fund must profile a typical anticipated investment, from a financial, management, market, and programmatic standpoint.

The fund must address at what stage it will be making investments in portfolio firms; seed, growth, expansion, or follow-on.[3]

The fund must describe its approach to due diligence, valuation, market and financial analysis, and deal negotiation, approval, and documentation. For example, the fund should articulate whether it plans to conduct these activities with its own staff or under contract with outside parties; the anticipated time line, process, level of due diligence; and the role of the Investment Review Committee, Board of Directors, and any advisory committees.

[3] See Appendix C, Growth Stage.

Presumably, most equity funds targeted by ARC would structure their investments as subordinated debt with profit participation or warrants, convertible debt, preferred stock, or common stock. Alternative structures must be detailed. The fund must project the anticipated term of investments. Additionally, the fund must outline anticipated management and board relationships with the portfolio companies. This includes whether the fund will take seats on the portfolio firm's board of directors or whether the fund will seek voting shares of common stock, majority voting rights exercisable under certain conditions, or other structures to ensure adequate safeguards of the fund's investments.

The fund must describe its projected range of investment sizes, as well as a projected average size of investment. For example, a $12 million fund may choose an investment range of $50,000 to $1,000,000, with a projected average investment of $300,000. The fund must also state the maximum percentage of assets that can be outstanding to one portfolio company. Equity funds often concentrate their investments to a greater degree than RLFs. Some funds allow as much as 15% or even 20% of their assets in a single investment, particularly if that includes a series of investments to a successful company. Equity funds will also tend to have a higher average investment size than RLFs, since each investment has higher transaction costs.

The fund must project its typical "hurdle" rate of return (the minimum rate an investment can reasonably be projected to achieve in order to be considered for evaluation) and the average rate of return on its investments. For example, a fund may project a hurdle rate of 25% annually per deal, with an overall projected return of 10% to 12% annually. The fund must clearly outline segmentation of deals by projected rates of return. For example, a fund may project that a portion of deals will return the target rate of return, a portion of deals will return only invested capital, and a portion of deals will be complete write-offs. The fund must also describe the circumstances, if any, under which it would accept a lower rate of return in exchange for enhanced programmatic impact.

Applicants must examine possible exit strategies and projected courses of action. Few companies receiving DVC investments can hope to go public. Thus, a fund must realistically plan to exit its investment through the sale of the company to another entity, a refinancing of the investment with debt, or payout through company cash flow. All of these events can have a material impact on the portfolio company if the equity fund's return is substantial.

e. Technical Assistance and Portfolio Administration. An equity fund adds additional value to portfolio companies through the provision of management assistance. An applicant equity fund must address how it plans to deliver technical assistance and how it will ensure the quality of this assistance. Areas of assistance could include: capital strategies; marketing or product assessment; strategic connections/partnerships; human resource issues; board development and financial management. The applicant should leverage existing community resources and previous ARC investments in the region to the extent possible.

The fund must articulate plans to utilize support from private sector technical assistance providers, including accounting firms, marketing firms, strategic consulting firms, engineering services, etc. The applicant must identify whether these relationships will be ad hoc, or if strategic alliances will be formed with a priority group of professionals.

Additionally, the fund must detail any partnerships it has with institutions such as Small Business Development Centers, business incubators, local community colleges and universities, area job training and placement programs, and Welfare-to-Work agencies. To the extent such existing assistance efforts are effective, duplication of these efforts must be avoided.

The applicant must detail how it plans to monitor investments and coordinate ongoing technical assistance. The fund should also address workout and non-performance issues, including: how to respond to issues of financial non-performance on the part of a portfolio company; how to respond to issues of social non-performance (failure to meet job creation or other social impact goals); when to take action related to non-performance; and what type of actions will be considered (such as the increase in the DVC Fund's equity stake, management changes, sale of the company, or liquidation of assets).

f. Programmatic Impact. Given the proposed market focus, an applicant must detail the programmatic benefits of a grant from ARC. For example, a fund may establish specific goals for jobs that pay a certain percentage of area median income or for jobs that use Welfare-to-Work participants. A fund may also target areas of high poverty. Applicants should provide a projected dollar amount that may be invested for each job created or saved. Projected outcomes, as itemized in Section II, Objectives and Strategies, above, should also be noted.

IV. ARC Development Venture Capital Fund Policies

The responsibility for approving equity investments and setting terms and conditions consistent with these guidelines resides fully with the Grantee. All ARC DVC Fund equity recipients must comply with the requirements of applicable Federal, State, and Local laws. Grantees must offer equity investment assistance by a formal commitment letter which shall include the equity investment terms offered, the conditions of the equity investment, and other equity investment documentation required. An equity recipient (portfolio firm) must sign an acceptance of the equity investment commitment offered.

For each equity investment made by a DVC fund, an equity investment agreement is required. The Equity Investment Agreement may include language that permits the immediate recovery of the equity investment, or an increase in the Grantee equity stake, if an equity investment is not used for the purpose represented in the equity investment application.

Grantees are responsible for operating ARC funded DVC Funds in accordance with the terms of the ARC Code, the approved DVC Fund business plan, the ARC DVC Fund Application and Operating Guidelines, and the grant agreement. Grantees must affirm that they understand and do agree to operate DVC Funds in accordance with these Application and Operating Guidelines and the submitted and approved DVC Fund business plan. ARC relies on affirmation from each Grantee's Chief Executive Officer to these Application and Operating Guidelines as a basis for releasing equity investment funds to the Grantee.

Grantees may request changes to their DVC Business Plan that improves DVC Fund administration and/or enhances the ability of the Grantee to meet the original objectives of the DVC Fund project. All such revisions to a Grantee's DVC Business Plan must be approved by ARC, in advance.

A Grantee's failure to comply with these Application and Operating Guidelines (including reporting requirements), the ARC code, the terms of the grant, or the approved business plan may be cause for terminating the grant. When grants are terminated for cause, ARC has the right to recover grant funds and/or the assets of the DVC Fund, in accordance with the legal rights of the Grantee and the Commission.

When a DVC Fund Grantee is no longer able or willing to carry out its responsibilities for administering the DVC Fund, those responsibilities may be transferred, with ARC approval, to another eligible entity with jurisdiction over the project area. Such action will be taken only if the need for the fund still exists and the original purpose and benefits of the project can still be achieved. If not, the grant will be terminated and all remaining grant funds will be returned to ARC.

Conflicts of Interest: Equity Investments that create a potential conflict-of-interest or the appearance of one for any officer or employee of a Grantee**,** any current member of a Grantee's equity investment review committee, administrative board, or staff that reviews, approves, or otherwise participates in decisions on DVC Fund equity investments, and people related to them by blood, marriage, or law are prohibited. Former members of the Board, former members of the staff, and former members of the Equity Investment Review Committee are barred from receiving ARC DVC Fund equity investment assistance for one year from the date of termination of their service. Equity investment activities that directly benefit these individuals or people related to them by blood, marriage, or law is prohibited for a period of one year from the date of termination of service of such related person.

Conflicts of Interest—Exceptions: In keeping with common practices in the venture capital industry, ARC would not prevent DVC Fund staff from serving as Board members of portfolio companies, since this would hamper their effectiveness and restrict a common industry practice. ARC requires that DVC Fund managers who are Board members return any compensation they receive as a Board member to the DVC fund itself.

V. Equity Recipients (Portfolio Firms) and Equity Investments

The following guidelines pertain to the use of ARC grant funds by a Grantee DVC fund.

A. Eligible Equity Recipients—Portfolio Firms

Private, for profit firms meeting the US Small Business Administration definition of small and medium sized enterprises (499 employees or less) that do business within the Appalachian Region are eligible for DVC Fund equity investments. Firms must include substantial U. S. citizens or legal resident ownership. The portfolio firm or any of its owners cannot have a delinquent debt to the Federal Government. The equity recipient, the activity financed and its benefits must be located within the Region.

B. Eligible Equity Investments

For each equity investment, portfolio firms must agree to create new jobs and/or save existing jobs within the Region and within a time frame to be prescribed by the DVC fund. ARC grants to DVC funds may be used for:

- Working capital including financing of inventory;
- Receivables financing;
- Product development and testing;
- Operating support for professional services, marketing activities, employee training, and other purposes to help portfolio firms;
- Machinery, equipment and other fixed asset acquisition including transportation/delivery and installation costs;
- Construction, alteration, modification, repair, and renovation of existing or new facilities;
- Refinancing existing debt, but only when used to expand the existing debt of the firm;
- Land acquisition. Up to 20% of a portfolio investment may be used for purposes of land acquisition, if the land purchase is part of a larger development project; or
- Operating costs of the DVC fund itemized in the fund business plan.

C. Equity Investment Projects Not Eligible for ARC Funds

The following types of equity investments are not eligible uses of ARC DVC funds:

- Grantees may not make investments to themselves or to a subsidiary**. (**Subsidiaries are organizations under common control through common officers, directors, members or employees.)
- Refinancing existing debt, except as noted above;
- Land acquisition, except as noted above;
- Investments in non-profit or governmental organizations;
- Investments in ARC designated Attainment counties. ARC participation in the funding provided to a portfolio company located in an ARC competitive county may not exceed 30% of the total project funding provided to that portfolio company; or
- Operating costs of the DVC fund <u>not</u> itemized in the fund business plan.

Economic benefits resulting from equity investment activities must be located within the Appalachian Region. ARC DVC Fund equity investment assistance must be withdrawn if for any reason the activity financed or the economic benefit is moved from the Appalachian Region.

VI. Development Venture Capital Fund Administration

ARC funded DVC funds must adhere to the terms and conditions noted in the grant agreement.

A. Use of ARC Grant Funds, Match Requirements

ARC grant funds may be used only to fund equity investments and operational costs of the DVC fund as itemized in the approved Business Plan and financial projections.

ARC requires that each fund match its investment at the fund level. Commitments from other fund investors should be itemized, and letters of commitment included in the application. ARC will not require a match at the individual deal level, as it does with its RLF program; however, certain restrictions may apply depending on the type of county in which the investment is made. In general, ARC may not provide more then 50% of the total corpus of a DVC fund. However, in practice DVC funds typically require multiple investors to meet their capitalization targets, and ARC's participation would likely provide only a small portion of the capital required by the fund.

At the individual deal level, no more then 30% of the project funding may be provided to a portfolio company in an ARC competitive county, and ARC participation is not permitted in an ARC attainment county.

B. Program Income—Use of Proceeds from DVC Fund Investments

All repayments of DVC Fund grant funds must be returned to the DVC Fund for subsequent venture capital investments. Proceeds from the sale, collection, or liquidation of investment assets must also be returned to the DVC Fund for venture capital investments. The reasonable costs of equity investment workouts may be treated as operating expenses.

1. Program income is the income received by the Grantee earned as a result of venture capital investing authorized by the grant agreement. All grant related program income shall be reported to ARC as noted in the grant agreement. Program income could include, but is not limited to, management fees, revenue from the successful exiting of a portfolio firm, etc.

2. Program income will be added to the equity investment fund to expand the DVC Fund capital base or used to cover reasonable operating costs of the DVC Fund, as itemized in the approved Business Plan.

3. Grantees must keep complete records, as noted in relevant federal circulars, to document operating costs.

C. Funds Management

1. Advances to DVC Funds—Grantees may request advance payments as necessary to facilitate the operation of the fund. Advance payments from ARC may be made in proportion to the matching funds received by the Grantee from non-ARC sources. For example, if ARC is to provide 20% of the first $5M in capital raised by a DVC fund, ARC may not advance a sum greater then 20% of the capital committed and received by the fund, until the first "closing" level of $5M is achieved.

2. Investment of DVC Fund balances—Grantees may place funds advanced from ARC or returned to the DVC Fund from venture capital activities in interest earning accounts pending the closing of new equity investments. Interest earning accounts may be Federally insured deposits, short term certificates of deposit that are covered by deposit insurance, or other secure

instruments. Income earned by a Grantee on funds advanced by ARC may be retained by the Grantee to offset operating costs itemized in the approved fund Business Plan.

If DVC fund activities are not being implemented in a manner consistent with the approved Business Plan, or in a timely fashion as described in the grant award and approved Business Plan, grant funds may be revoked, recovered, or deobligated.

D. Reporting

During the term of the ARC grant agreement, the Grantee must submit semi-annual (6-month) reports to ARC describing programmatic activities and the financial status of the fund. These reports should include:

- Complete financial statements for the DVC Fund, including income statement, balance sheet, and cash flow reports;
- A narrative report describing project activity, to include information about deal flow, investments reviewed, technical assistance provided, and pending investments;
- For current investments, a description of the portfolio firm, the structure of the investment, recent business challenges and opportunities impacting the firm, and the projected valuation of each investment;
- For each investment exited, the final valuation of the investment and the structure and term of the concluding transaction; and
- The report should also address any strategic issues or concerns of note facing the fund.

Once a DVC fund has demonstrated an acceptable level of capability, principally by managing portfolio investments through to successful exit, ARC may modify project reporting requirements requiring only annual reports be submitted.

E. Financial Audits

Grantees that expend $300,000 or more in a year in Federal grant awards, including the DVC Fund award, shall have a single or program-specific audit conducted for that year as prescribed by OMB Circular A-133. Grantees must notify auditors that the Catalog of Federal Domestic Assistance number for ARC DVC Fund's is 23.011, Appalachian State Research, Technical Assistance, and Demonstration Projects.

Grantees that expend less than $300,000 a year in Federal awards including the DVC Fund award, are exempt from audit for that year. However records must be available for review or audit by appropriate officials of the granting agency.

Audits must be performed by a public accountant or a Federal, State, or local government audit organization which meets the general standards specified in Generally Accepted Government Auditing Standards issued by the Comptroller General of the United States (known as the Yellow Book). Audits must conform to these standards.

Grantees are responsible for internal control over Federal programs that provide reasonable assurance that they are managing the DVC Fund in compliance with laws, regulations, and the provisions of grant agreements.

Grantees must maintain financial management systems and retain financial records in accordance with standards prescribed in OMB Circular A-102 and/or Circular A-110. Grantee records and accounting systems must include an accurate accounting for any equity investment fees or other income generated by the DVC Fund and must document how these funds are used.

Administrative expenses paid from program income generated by the DVC Fund must be documented for grant audits.

F. Project Monitoring

ARC monitors grant performance through semi-annual (6 month) reports submitted by the Grantee, audit findings, biannual (two year) site visits, and other necessary contact with the Grantee. Once a DVC fund has demonstrated an acceptable level of capability, principally by managing portfolio investments through to successful exit, ARC may modify project reporting and monitoring requirements, requiring only annual reports and eliminating biannual site visits.

G. Termination of ARC Grant

A Grantee's failure to comply with these Application and Operating Guidelines (including reporting and monitoring requirements), the ARC code, the terms of the grant, or the approved business plan may be cause for terminating the grant. When grants are terminated for cause, ARC has the right to recover remaining grant funds and/or the assets of the DVC Fund, in accordance with the legal rights of the Grantee and the Commission.

When a DVC Fund Grantee is no longer able or willing to carry out its responsibilities for administering the DVC Fund, those responsibilities may be transferred, with ARC approval, to another eligible entity with jurisdiction over the project area. Such action will be taken only if the need for the fund still exists and the original purpose and benefits of the project can still be achieved. If not, the grant will be terminated and all remaining grant funds and/or the assets of the DVC Fund, in accordance with the legal rights of the Grantee and the Commission, will be returned to ARC.

Appendix A
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Appendix B
Resources

Community Development Finance
Institutions Fund (CDFI)
Department of the Treasury
601 13th Street, NW, Suite 200-South
Washington, DC 20005
Phone: 202-622-8662 Fax: 202-622-7754
www.treas.gov/cdfi/

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Appendix C
Growth Stage of Portfolio Firm

Seed investments are made in early stage or start-up companies developing new products and markets. Growth investments are made in revenue-producing companies that are seeking to enter new markets or expand product lines. Expansion investments are made in established companies with growth opportunities in their current or directly related markets. Follow-on investments are made to successful companies already in the equity fund's existing portfolio.

Seed investments in particular require a high degree of industry or venture capital expertise, since they are the riskiest (but often offer the highest potential rate of return). Later stage companies have more financial history, tend to have identified markets and usually have management that is proven in that particular business. To a certain extent, funds that serve mature or growing markets have more options with respect to the stages at which they will be making investments. Funds in markets that have low levels of economic activity could be forced to make investments in companies at an earlier stage of development.

Additional information regarding types of equity investments can be found at the National Venture Capital Association web site: www.nvca.org/